In the
Supreme Court of the United States

OCTOBER TERM, 1980

No. 79-877

JOSEPH LORCH and HANNAH LORCH,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MICHAEL T. HARGES and JANET G. HARGES,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

LEONARD BAILIN
299 Broadway
New York, N.Y. 10007
Counsel for Petitioners

DICK BAILEY PRINTERS, 290 RICHMOND AVE., S.I., N.Y. 10302
TELEPHONE: (212) 447-5358

TABLE OF CONTENTS

CITATIONS

Cases:

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1980

No.

JOSEPH LORCH and HANNAH LORCH,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MICHAEL T. HARGES and JANET G. HARGES

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above entitled proceeding on September 5, 1979.

CITATIONS TO OPINIONS BELOW

The findings of fact and opinion of the United States Tax Court (R. 1a) is reported in 70 T.C. No. 65. The opinion of the United States Court of Appeals for the Second Circuit is not yet officially reported but is cited as No. 1097, Slip opinion Pages 4493 through 4502, Decided September 5, 1979 (C.C.A. 2nd). (R. 15a) Both opinions are printed in Appendix A hereto.

JURISDICTION

The judgment of the United States Court of Appeals for the Second Circuit was entered September 5, 1979, Appendix A, P. 1a infra. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

STATEMENT OF THE FACTS

In January of 1962 taxpayer petitioners entered into separate agreements with Hayden, Stone & Company, Inc. a brokerage firm, designed to help Hayden Stone meet the minimum capital requirements of the New York and American Stock Exchanges. The agreements, similar to those Hayden Stone had with over one hundred other investors, required Lorch and Harges each to give to Hayden Stone a non-interest bearing promissory note in the face amount of $100,000, and as collateral thereto, to turn over securities to Hayden Stone to be held by them for the duration of the agreement. The notes provided that petitioners should not be personally liable thereon, that any liability should be limited to the value of the pledged

securities, and that Hayden Stone should look for payment solely to the property pledged. Each could withdraw any of the securities provided that they were replaced by cash or other securities of equivalent value. Each petitioner retained full legal and beneficial ownership of his securities, including the right to vote as a shareholder and to receive dividends, interest or income distributions.

In return for these obligations undertaken by Lorch and Harges, Hayden Stone agreed to pay them five percent annually on the face amount of their notes. Additionally, Hayden Stone was required, in the event that it demanded payment on the promissory notes, to give to each petitioner the firm's subordinated debentures at six percent interest in the face amount equal to the amount realized by Hayden Stone upon liquidation of the collateral. This six percent debenture was to be subordinate to all claims of all creditors of Hayden Stone.

The agreements between the petitioners and Hayden Stone were terminable by either party upon six months written notice.

Lorch and Harges maintained their collateral accounts with Hayden Stone and received the five percent annual fee called for by the agreement from 1962 until 1970. In 1970, however, Hayden Stone faced severe financial difficulties and consequently demanded that its subordinated lenders, Lorch and Harges included, pay their secured notes or face liquidation of the collateral in their accounts. Subsequent to the demand, all of Lorch's securities were liquidated, with a resulting net loss to him which amounted to $91,101.59. This amount primarily represented the value of the collateral securities on the date of liquidation. In response to the demand for payment, Harges took back substantially all of the collateral securities and paid to Hayden Stone a net amount of $88,592.48, which was the value of the collateral securities on the date of their proposed liquidation.

During the period June 1970 through September 1970 Hayden Stone conducted various negotiations directed toward the liquidation of its business. In the face of a threatened

bankruptcy and the imminent worthlessness of their rights to these subordinated debentures, substantially all of the subordinated creditors consented to accept preferred stock of H. S. Equities, Inc. (the new name of Hayden Stone after its own name had been sold in liquidation) in lieu of the subordinated debentures which they could have received. The aggregate par value of the preferred stock received was the amount realized upon the liquidation of each creditor's collateral. It was stipulated between the parties that at the time of receipt, the $100 par value preferred stock had an actual value of $20 per share.

Hayden Stone, now bearing the name H.S. Equities, Inc., proceeded with the liquidation of its entire business, which liquidation has continued for many years and has now been substantially accomplished. Lorch and Harges each claimed ordinary loss deductions under Section 165(c)(2) of the Internal Revenue Code on their 1970 Federal Income Tax returns in the amount by which the cash in their collateral accounts plus their basis in the securities liquidated by Hayden Stone exceeded the fair market value of the Hayden Stone preferred stock they ultimately received.

QUESTIONS PRESENTED

The questions presented are as follows:

Where the subordinated lender petitioners have sustained losses as a result of the sale and liquidation of their collateral securities to pay the creditors of the broker:

a. Were the taxpayer petitioners' losses non-business bad debts under Section 166(d) of the Internal Revenue Code, or

b. Were they losses from the sale or exchange of a capital asset under Section 165(g) of the Internal Revenue Code, or

c. Did the transactions result in a recapitalization under Section 368(a)(1)(E) of the Internal Revenue Code, or

d. Did such losses result from a transaction entered into for profit within the meaning of Section 165(c)(2) of the Internal Revenue Code?

STATUTES

The pertinent provisions of the United States Internal Revenue Code of 1954, adopted by Act of August 18, 1954 are set forth in Appendix B.

STATEMENT

Petitioners duly filed their petition for a redetermination of their personal income tax liability with the United States Tax Court for the calendar year 1970. The United States Tax Court had jurisdiction over the proceeding in the first instance, in accordance with Section 7442 of the United States Internal Revenue Code of 1954. The United States Tax Court rendered its findings of fact and opinion on August 15, 1978 (R. 8a), and entered its decision on December 5, 1978, on the basis of the pleadings, oral testimony, arguments and briefs.

The following decision was rendered by the United States Tax Court:

a. Petitioners are not entitled to any ordinary loss under Section 165(c)(2) of the Internal Revenue Code.

b. The petitioners sustained capital losses upon the sale of their collateral securities equal to the excess of their basis over the sales prices.

c. The loss of the proceeds of such sale is not recognized because the petitioners were entitled to receive subordinated debentures in that amount.

d. The surrender of these rights to debentures for preferred stock in lieu thereof was pursuant to a recapitalization under Section 368(a)(1)(E) of the Internal Revenue Code, and no loss is recognized as a result thereof.

The court below agreed with all the findings of the United States Tax Court. In so finding, the Circuit Court rejected the petitioners' arguments that the loss was the result of a transaction entered into for profit and should be allowed as an ordinary loss deduction.

In rendering its decision, the court below refused to follow the decisions handed down by one other circuit and by the United States Court of Claims in which contrary decisions involving the same basic factual circumstances were reached.

Stahl v. United States, 441 F.2d 999 (C.A.D.C. 1970).
Michtom v. United States, 573 F.2d 58 (Ct. Cl. 1979).

REASONS FOR GRANTING THE WRIT

1. The action of the court below in holding that the loss sustained by a subordinated lender under the circumstances set forth herein does not give rise to an ordinary loss deduction under Section 165(c)(2) of the Internal Revenue Code as a result of a transaction entered into for profit creates a direct conflict between the Second Circuit and the Circuit Court of Appeals for the District of Columbia and the United States Court of Claims.

Stahl v. United States, supra
Michtom v. United States, supra

2. The factual situation in this case involves the same basic factual circumstances as the *Stahl* case.

a. Both agreements arose out of the same necessity wherein the brokerage firm was required to acquire additional capital by the Stock Exchanges and/or the Securities Exchange Commission.

b. The original agreements in both cases were entered into in the early part of 1962.

c. In the *Stahl* case the petitioner agreed to loan to Balogh (the broker) certain securities pursuant to a subordination agreement. In this case the securities were loaned to Hayden Stone as collateral for a promissory note upon which there was no personal liability, pursuant to the subordination agreement.

d. Both parties agreed to subordinate to the claims of all present and future creditors to the extent of the securities which had been advanced.

e. In *Stahl*, the lender was to receive as a fee 1% of the market value of the securities per quarter, and in this case the lenders were to receive 5% per annum.

f. Both security agreements set forth a time period for cancellations; in the *Stahl* case the time period was thirteen months from the date of the agreement and in this case the time period was six months notice.

g. The subordinated lenders in both cases understood and agreed that the securities advanced as collateral might be used and dealt with by the broker as part of its capital and were subject to the risks of the broker's business and subordinate to the claims of *all* other creditors.

The only distinction between the two cases arises from the fact that *Stahl* ended up with a claim against the broker after she sustained her loss, whereas Lorch and Harges ended up with a right to a subordinated debenture as evidence of their claim against the broker after they had sustained their loss. This minor distinction in drafting the form of the two agreements does not change the fact that both agreements were made at about the same time, under the same circumstances, for the same reason and both terminated with a similar net result. There can be no doubt that the substance of the transactions in *Stahl* is identical to those in this case.

The Circuit Court in *Stahl* found that no debtor-creditor relationship existed in the case of a subordinated lending transaction. The Court stressed the real intention of the parties. In reply to the Government's contention that a debt subsequently arose after the loss had been sustained, the Court stated:

> "In our view the corporation's undertaking to taxpayer was not a 'debt.' The transaction is too substantial a departure from the essence of the concept of 'debt,' both the classic concept and the concept set forth in the Treasury's Regulations. ' . . . We conclude that what is involved constitutes neither a debt nor a capital contribution but is a bailment transaction entered into for profit but with risk of loss.' "

In contrast, the Circuit Court for the Second District found that because of petitioners' status as creditors of Hayden Stone and because the fixed nature of Hayden Stone's obligation to repay them was made unmistakably clear by petitioners' entitlement to the firm's debentures in the event their notes were called, a debtor/creditor relationship was thereby established with a resulting non-business bad debt loss rather than an ordinary loss. This identical argument was raised in the *Stahl* case but was rejected by the Court:

> "The taxpayer here did not guarantee Balogh's debts; she gave that company securities for its use in satisfaction of the SEC capital requirements, in the expectation of a 1% per quarter return (over and above the dividends and interest received from the securities). When taxpayer's securities were sold by Balogh she suffered a loss. She was not subrogated to any pre-existing debt of the corporation to its creditors."

In upholding its decision that the loss sustained was deductible on a transaction entered into for profit the *Stahl* court went on to say:

> "The only intention of taxpayer here was the expectation of compensation received directly, as payment for the availability of taxpayer's securities. This transaction was plainly one entered into for profit."

The Circuit Court of Appeals for the Second Circuit does not recognize this reality, finding an intention to create a loan arising out of the fact that the subordinated lenders were entitled to debentures of Hayden Stone as evidence of their ultimate losses. The loss of their securities must have been the last thing they intended!

The Circuit Court of Appeals for the Second Circuit then finds that the exchange of the right to debentures for preferred stock of H. S. Equities, Inc. constituted a recapitalization pursuant to Section 368(a)(1)(E) of the Internal Revenue Code.

This finding was never contemplated in the *Stahl* case, nor was it contemplated in the *Michtom* case set forth below. Is it not obvious that if in fact there was a recapitalization, it occurred only after the loss had been established?

3. The factual situation in the case of *Michtom vs. United States, supra,* decided on March 22, 1978 by the United States Court of Claims is identical to the facts in this case. Benjamin F. Michtom was another one of the subordinated lenders of Hayden Stone. He executed an identical agreement and the factual pattern in that case is identical to the factual pattern herein. The United States Court of Claims found that the subordination agreement rights which Mr. Michtom had were not capital assets and that the plaintiffs are entitled to an ordinary loss deduction for the losses which they sustained. In deciding that the loss deduction was allowed under Section 165(c)(2) of the Internal Revenue Code the Court cited *Stahl* and agreed with the reasoning therein.

4. The Court of Appeals for the Second Circuit in its decision, appealed from herein, cites no cases to support its decision, but bases its decision solely on differences in draftsmanship between the agreements in *Stahl* on the one hand and the agreements in *Michtom* and in this case on the other hand. The Court fails to recognize that the substance of the agreements is identical and that even the technical differences are insignificant.

5. There were 107 subordinated lenders involved in similar transactions with Hayden Stone. 106 of them have sustained losses similar in nature to the losses sustained by the petitioners herein. There are a great many cases still pending in the various divisions of the Internal Revenue Service and in the Courts. I have been contacted on several occasions by attorneys throughout the United States who are interested in the ultimate decision in this case because they have similar cases pending. A final decision of the Supreme Court of the United States would settle the law in all of these pending actions.

CONCLUSION

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

LEONARD BAILIN
299 Broadway
New York, N.Y. 10007
Counsel for Petitioners

APPENDIX "A"

70 T.C. No. 65

UNITED STATES TAX COURT

JOSEPH LORCH and HANNAH LORCH,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MICHAEL T. HARGES and JANET G. HARGES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket Nos. 5315-75, 9654-75.
Filed August 15, 1978

In 1962, petitioners entered into an arrangement whereby cash and securities owned by them (approximately $100,000 in value for each) would be held by HS, would be subordinated to the claims of HS' creditors, and, upon notification of HS, would be liquidated and the proceeds utilized by HS. *Petitioners*

were to be paid $5,000 annually by HS under the arrangement. In the event that petitioners' securities were liquidated, they would be entitled to receive subordinated debentures in the face amount of the proceeds of liquidation and cash deposited with HS. HS gave the necessary notice to petitioners in June 1970. The stock not returned to petitioners was subsequently sold by HS at prices less than petitioners' bases therein. Petitioners later in 1970 exchanged their subordinated debenture rights for senior preferred stock in the same corporation. *Held*, petitioners are not entitled to any ordinary loss under sec. 165(c)(2), IRC 1954. *Held further*, petitioners sustained capital losses upon the sale of their securities equal to the excess of their bases over the sales prices. *Held further*, no additional loss is recognized as a result of the acquisition of their rights to receive subordinated debentures. *Held further*, the exchange of debenture rights for preferred stock was pursuant to a recapitalization under sec. 368(a)(1)(E), IRC 1954, and no loss is recognized as a result thereof. Sec. 354(a), IRC 1954.

Leonard Bailin, for the petitioners.

L. William Fishman, for the respondent.

TANNENWALD, *Judge:* Respondent determined the following deficiencies in petitioners' Federal income taxes:

Taxpayer	*Year*	*Deficiency*
Joseph Lorch and Hannah Lorch	1970	$61,134.00
Michael T. Harges and Janet G. Harges	1970	$35,650.13
	1971	$ 1,079.00

The sole issues for decision are the extent to which petitioners sustained deductible losses in 1970 and the nature of any such losses, i.e., capital or ordinary.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and the exhibits attached thereto are incorporated herein by reference.

Joseph Lorch (Lorch) and Hannah Lorch were legal residents of New York, New York, and Michael T. Harges (Harges) and Janet G. Harges were legal residents of New Canaan, Connecticut, at the time the petitions herein were filed. Each couple filed joint Federal income tax returns for the taxable years at issue. The respective wives are parties to this proceeding only by virtue of having joined in filing such returns.

On January 2, 1962, Lorch and Harges (hereinafter referred to as petitioners) entered into arrangements with Hayden, Stone & Co., Inc. (Hayden Stone) whereby each agreed to deposit cash and securities in an account with Hayden Stone and to subordinate his rights to these assets, which were placed in a "subordinated" account. Each of them also delivered to Hayden Stone a non-interest-bearing promissory note for $100,000, on which his liability was expressly limited to the assets in his subordinated account.

Hayden Stone was required to notify each petitioner before it could sell the assets in the subordinated account. Upon notification from Hayden Stone, each petitioner had the option of substituting cash and/or securities equal in value to the subordinated account assets or permitting such assets to be liquidated.

At such time as his account was liquidated, each of the petitioners was to be entitled to receive a 6-percent subordinated debenture from Hayden Stone in the principal amount equal to the amount paid on his indebtedness represented by his note. Pending the issuance of the subordinated debenture, he would have the rights of a "subordinated lender."

Subject to the above, each petitioner maintained virtually full legal and beneficial ownership of the assets in his account.

In particular, he retained the benefit of any increases and bore the risk of any decreases in value, the right to vote or consent with respect to securities, the sole right to any income therefrom or distributions thereon, and the obligation to pay all taxes imposed on the income so derived. Each petitioner could sell the securities or use any cash in his account to purchase securities, provided that the net proceeds of the sale and the securities so purchased were to be retained in the account. He also could replace any security with cash or securities of no lesser value.

Each petitioner had the right to terminate the arrangement by giving six months' written notice. If, during this six-month period, Hayden Stone notified him that the assets contained in the account were to be liquidated, the arrangement would not be terminated.

These arrangements helped Hayden Stone satisfy the minimal capital requirements as set forth in Rule 325 of the New York Stock Exchange and Rule 466 of the American Stock Exchange. Lorch and Harges were each to be paid annually 5 percent of his indebtedness, i.e., $100,000.

On June 26, 1970, Hayden Stone was in financial difficulty. It demanded payment from each petitioner of his note and stated that, if not paid, the collateral would be liquidated. Lorch then deposited $10,000 with Hayden Stone. Dividends, interest, and a pre-existing credit balance, amounting in the aggregate to $1,074.75, were retained by Hayden Stone and this amount was credited to Lorch's account. Except for some common stock subsequently returned to him, Lorch permitted Hayden Stone to liquidate his subordinated account securities, for which it received $80,026.84. Lorch's cost basis in the securities sold was $126,005.51. Each security was sold for less than its cost. The total amount used to satisfy his obligation to Hayden Stone was $91,101.59.

Upon receiving notice from Hayden Stone, Harges paid, or caused to be paid to Hayden Stone on his behalf $66,862.05. Hayden Stone retained interest and dividend income, aggregating $2,269.70, and credited this amount to Harges.

Hayden Stone was permitted by Harges to liquidate one bond, for which it received $19,460.73. Harges' cost basis in this bond was $20,000. Hayden Stone returned the remainder of Harges' securities to him. The total amount used to satisfy Harges' obligation to Hayden Stone was $88,592.48.

On September 4, 1970, Cogan, Berlind, Weill & Levitt, Inc. (CBWL) and Hayden Stone entered into an agreement whereby CBWL agreed to purchase certain assets (including use of the name Hayden Stone) and to assume certain liabilities of Hayden Stone. The agreement required that all of the subordinated creditors of Hayden Stone, including petitioners, consent to the transaction and agree to withhold the exercise of any claims against Hayden Stone. These creditors were told that, unless they consented, they would receive nothing on their claims. Of the 108 subordinated creditors, 107, including petitioners, consented, and the agreement was consummated.

In order to replace a negative net worth of $5,474,010 as of July 31, 1970, with a positive net worth of $25,827,832 and to reduce the possibility of H.S.E. (to which Hayden Stone's name would be changed) being placed in liquidation under court supervision, it was proposed that the subordinated lenders accept preferred stock in satisfaction of their claims against Hayden Stone.

Under the terms of the proposal, Lorch and Harges each agreed to accept one share of $6 senior voting preferred stock of H.S.E. ($100 liquidating value) for each $100 of claims. On September 10, 1970, Lorch received 911.01 shares and Harges received 885.92 shares. At the time of receipt, the preferred stock had a value of $20 per share. As of the time of trial, petitioners had not sold their preferred stock in H.S.E.

It was anticipated that H.S.E. would dispose of its remaining assets and pay all unassumed liabilities but would not otherwise engage in business.

Neither Lorch nor Harges was ever an employee, officer, director, or stockholder of Hayden Stone, nor have they ever been in the business of buying, selling, or trading securities.

The petitioners claimed deductions under section 165(c)(2)[1] in the amount by which their bases in the securities held by Hayden Stone exceeded the fair market value of the H.S.E. preferred stock received. In the notice of deficiency in docket No. 5315-75 (Lorch), respondent determined that the deductible losses were limited to the excess of Lorch's bases in the liquidated securities over the amount realized by Hayden Stone on their sale and should be treated as capital losses. In the notice of deficiency in docket No. 9654-75 (Harges), respondent disallowed the entire claimed deduction on the ground that no deductible loss had been established and, alternatively, that, if any deductible loss occurred, it was not an ordinary loss.

OPINION

Petitioners urge that we take a unitary view of their arrangements with Hayden Stone and that, accordingly, they sustained losses measured by the difference between their cost of the securities held in the subordinated accounts (including the securities returned to them) and the fair market value of the preferred shares of H.S.E. which they received. Such losses, they contend, should be held to be ordinary losses incurred in a transaction entered into for profit under section 165(c)(2)[2] and

1. All section references, unless otherwise indicated, are to the Internal Revenue Code of 1954, as amended and in effect during the years at issue.

2. Section 165 provided in pertinent part as follows:

SEC. 165. LOSSES

(a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * *

(c) Limitation on Losses of Individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

* * *

(f) Capital Losses.—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

therefore deductible in full. Respondent counters that there were two parts to the 1970 implementation of the arrangements between petitioners and Hayden Stone: (a) the sale of the securities held in the subordinated accounts by Hayden Stone as petitioners' agent and for their account, with resultant capital losses in accordance with the limitation of section 165(f) (see footnote 2, *supra*) measured by the excess of petitioners' bases in the securities sold over the amount realized on their sale and (b) the acquisition of the H.S.E. preferred shares in exchange for petitioners' claims against Hayden Stone, including their rights to receive subordinated debentures, as to which no loss should be recognized in 1970 because the shares were received in a reorganization which constituted a recapitalization within the meaning of section 368(a)(1)(E). For the reasons hereinafter set forth, we agree with respondent.

Initially, we dismiss, as being without merit, petitioners' argument that the cost of the securities in the subordinated accounts, which were returned to them by Hayden Stone, should be included in the measure of any loss which they may have sustained. They simply received back securities which belonged to them. The fact that they paid certain amounts in cash to Hayden Stone does not require a contrary conclusion. The amounts of cash were paid by way of substitution of collateral pursuant to their arrangements with Hayden Stone. To the extent that they sustained losses beyond those resulting from the sale of their securities, such amounts of cash are includable in the measure of such losses.

We also note at the outset that the parties are in agreement that the petitioners entered into the arrangements with Hayden Stone in the hope and expectation of profit. But, as we stated in *Siple v. Commissioner,* 54 T.C. 1, 10 (1970), "[w]hile the existence of a profit motive is obviously a necessary element, it is not in and of itself a ticket for an ordinary loss deduction under section 165(c)(2) without regard to section 165(f)."

We think it cannot be gainsaid that petitioners remained the owners of the deposited securities from the inception of

their arrangements with Hayden Stone until the securities were sold. They retained all the rights of ownership throughout that period. In substance, Hayden Stone was petitioners' bailee. See *Miami National Bank v. Commissioner,* 67 T.C. 793, 800-801 (1977); *In re Bradford's Estate,* 165 Misc. 520, 300 N.Y.S. 92 (Surr. Ct. 1937).[3] As a result, the sale of those securities by Hayden Stone was for their account and they are required to recognize the losses from such sales as if the sales had been made by them directly. Unquestionably, the securities were capital assets in the hands of petitioners and the losses sustained on their sale, measured by the difference between their cost and the sales price, were consequently capital losses subject to the limitation of section 165(f).

The question remains as to whether petitioners suffered further loss upon the disposition of the proceeds of the sales and of the additional cash which petitioners furnished Hayden Stone pursuant to the arrangements. Petitioners in effect claim that their arrangements with Hayden Stone continued to partake of the character of a bailment and that their losses became deductible under section 165 at the point of time when they were "sold out," relying on *Stahl v. United States,* 441 F.2d 999 (D.C. Cir. 1970), affg. 294 F. Supp. 243 (D.D.C. 1969), and *Michtom v. United States,* ____ Ct. Cl.,____, ____F.2d____ (1978). See pp. 17-21, *infra.* We think petitioners' view of the arrangements ignores the fact that they had the right to receive subordinated debentures, which they exchanged for preferred stock, and the consequences flowing therefrom.

One way to view the arrangements is that petitioners either used their cash to acquire subordinated debentures, or the preferred stock in lieu thereof, pursuant to their previously undertaken obligation. Although the value of that property had declined and they "parted with more than they received,"[4] no

3. Compare *Clyman v. Commissioner,* T.C. Memo. 1977-200.

4. The debentures to which petitioners were entitled were to have been issued on a dollar-for-dollar face value basis. The preferred stock was issued on the same basis but had an actual value of only 20 percent of face at the time of issuance.

loss would be deductible until the property acquired was disposed of in a taxable transaction. Cf. *Loewi & Co. v. Commissioner,* 23 T.C. 486, 493 (1954), affd. 232 F. 2d 621 (7th Cir. 1956). See also *Jordan v. Commissioner,* 60 T.C. 872, 879 (1973), affd. per curiam 514 F. 2d 1209 (8th Cir. 1975). In this connection, we note that there is nothing in this record to indicate that petitioners' rights to the debentures were without value at the time of the exchange so that petitioners might be considered to have suffered a bad debt loss separate and apart from the exchange. Cf. *Mitchell v. Commissioner,* 187 F. 2d 706 (2d Cir. 1951), revg. and remanding 13 T.C. 368; *Levine v. Commissioner,* 31 T.C. 1121 (1959).[5] Nor is it significant that the debentures were apparently never issued by Hayden Stone. Petitioners' rights to the debentures can be treated as the equivalent of the debentures themselves for the purposes of this case. Cf. *Gawler v. Commissioner,* 60 T.C. 647 (1973), affd. per curiam 504 F. 2d 425 (4th Cir. 1974).

Another and perhaps more realistic approach is to look to the exchange by petitioners of their rights to receive subordinated debentures for preferred stock. The critical question then arises whether the exchange of the rights to the debentures for the preferred stock was pursuant to a recapitalization under section 368(a)(1)(E) so that no loss should be recognized by virtue of section 354(a). Petitioners seek to avoid the characterization of a recapitalization by arguing that H.S.E. was in the process of liquidation and that consequently the requirement of "business purpose" has not been satisfied.[6]

5. See also *IDI Management, Inc. v. Commissioner,* T.C. Memo. 1977-369. In any event, petitioners rely only on section 165 and make no contention that they are entitled to either a business or nonbusiness bad debt loss under section 166.

6. Petitioners do not argue that the prerequisites of recapitalization are not satisfied for any other reason, nor do they dispute respondent's contention that, if there is a recapitalization, no loss is recognized pursuant to section 354(a).

Neither the Code nor the regulations define the term "recapitalization." In general terms, it is a "reshuffling of a capital structure within the framework of an existing corporation." *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 202 (1942). In *Commissioner v. Neustadt's Trust*, 131 F.2d 528, 530 (2d Cir. 1942), affg. 43 B.T.A. 848 (1941), the court stated that "recapitalization" should be broadly construed to satisfy dual Congressional purposes, i.e., "to encourage legitimate reorganizations required to strengthen the financial condition of a corporation, and to prevent losses being established by bondholders, as well as stockholders, who have received the new securities without substantially changing their original investment. Section 1.368-2(e)(1), Income Tax Regs., gives the exchange of bonds for preferred stock as an example of a recapitalization.

In the instant case, petitioners acquired voting rights in H.S.E. and they became stockholders in, rather than creditors of, H.S.E. In terms of their claim to the assets of H.S.E., the switch from subordinated creditors to senior stockholders had virtually no substantive effect. Except for the change in voting rights, their stake in H.S.E. was not affected. There simply was no "substantial change" in petitioners' investment and, under the second element of the standard set forth in *Commissioner v. Neustadt's Trust*, *supra*, gain or loss should not be recognized. See also *Hickok v. Commissioner*, 32 T.C. 80 (1959).

Moreover, we think that, unlike *Graham v. Commissioner*, 37 B.T.A. 623, 630 (1938), upon which petitioners also rely,[7] the business purpose test has been satisfied in the instant case. The issuance of the preferred stock was undertaken to reduce H.S.E.'s debt and increase its equity on its financial statement, thereby reducing the possibility of H.S.E. being placed in liquidation under court supervision. Although H.S.E. was to sell its assets and repay its outstanding liabilities, the recapitalization was not merely one step in a liquidation masquerading as a reorganization. There is simply no basis for arguing "that this transaction was a shield for a distribution of dividends or for some other improper purpose." See *Kaufman v. Commissioner*, 55 T.C. 1046, 1054 (1971). See also *Bazley v. Commissioner*, 331 U.S. 737 (1947); *Commissioner v. Capento Securities Corp.* 140 F. 2d 382 (1st Cir. 1944), affg. 47 B.T.A. 691 (1942); Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, par. 14.51 (3d ed. 1971). We conclude that there was a recapitalization for purposes of section 368(a)(1)(E) and that no loss should be recognized.[8]

7. See also *Standard Realization Co. v. Commissioner*, 10 T.C. 708, 715 (1948).

We recognize that our analysis and conclusions differ from those articulated in *Stahl v. United States*, 441 F.2d 999 (D.C. Cir. 1970), affg. 294 F. Supp. 243 (D.D.C. 1969), and *Michtom v. United States*, ____Ct. Cl.____, ____F.2d____ (1978), both of which involved arrangements whereby securities were loaned under a subordination agreement for the purpose of improving the capital position of the borrower in return for the payment of compensation therefor. However, for reasons hereinafter set forth, we consider *Stahl* distinguishable and that we should not follow *Michtom* to the extent that it may be said to apply to the instant case.

In *Stahl*, the only issue was whether the taxpayer's loss, measured by her cost of the securities which had been sold by a brokerage firm to whom she had loaned the securities, was limited by the provisions of section 166 governing deductions for bad debts. The proceeds of sales exceeded the taxpayer's cost so that, in point of fact, there was a gain realized. The

8. The respondent raised the recapitalization issue by way of an amendment to his answer, so the burden of proof was upon him with respect to the factual underpinning of his legal position. See Rule 142(a), Tax Court Rules of Practice and Procedure. We are satisfied that he has carried such burden.

Government did not seek to tax the gain, presumably because the taxpayer would have been entitled to an offsetting loss. The taxpayer did not seek to claim the benefits of long-term capital gain treatment on the excess of the sale proceeds over her cost and then claim an increased ordinary loss. See *Santa Anita Consolidated, Inc. v. Commissioner,* 50 T.C. 536, 561-562 (1968), and cases cited thereat. Consequently, the court was not asked to decide whether there were separate transactions, rather than one, and to deal with the question of separate tax treatment of such sales. It therefore focussed only on the second aspect of the situation, namely, the nature of the taxpayer's loss from her failure to receive her securities from the brokerage firm. Under her agreement, the taxpayer's only right was to have her securities returned to her, except to the extent that they were needed by the firm. The district court and the court of appeals found that the arrangement constituted a bailment throughout (a characterization which we have adopted herein up to and including the sale of the securities which petitioners delivered to Hayden Stone)[9] rather than a debtor-creditor relationship and that accordingly the provisions of section 166 were inapplicable. Unlike the instant case, where petitioners were entitled to receive subordinated debentures in the event that their securities were sold, the taxpayer in *Stahl* had no right to receive, nor did she receive, anything from the brokerage firm except damages for breach of the bailee's obligation to her. *Stahl* is therefore clearly distinguishable.[10]

In *Michtom v. United States, supra,* the taxpayer also loaned his securities to Hayden Stone under arrangements similar to

---

9. The bailment characterization, in any event, would not include the additional cash which petitioners paid to Hayden Stone. See *Clyman v. Commissioner, supra.*

10. The same reasoning distinguishes *Ansley v. Commissioner,* 217 F.2d 252 (3d Cir. 1954), revg. on this issue a Memorandum Opinion of this Court. Compare *Sitterding v. Commissioner,* 20 T.C. 130 (1953); *Copley v. Commissioner,* T.C. Memo. 1968-77.

those involved herein. The Court of Claims ignored the Government's assertion that the arrangements should be viewed as involving separate transactions between the taxpayer and Hayden Stone and took a unitary view of those arrangements. It then proceeded to hold that the taxpayer incurred a deductible ordinary loss in 1970 measured by the difference between the basis of the securities sold and the market value of the preferred stock of H.S.E. which the taxpayer received. We do not understand the failure of the Court of Claims to treat the sales of the taxpayer's securities as a separate transaction and, in any event, disagree with its opinion to the extent that it can be said to hold that such sales should not be so treated. See discussion at pp. 11-12, *supra.* With respect to the exchange, whereby the taxpayer received H.S.E. preferred stock for his subordinated claim against Hayden Stone, we note that the Government did not argue that this was pursuant to a recapitalization, as the respondent has urged herein. Thus, that issue was not before the Court of Claims and *Michtom* is therefore distinguishable from the instant case in respect of the treatment of petitioners' losses on their exchanges.[11]

---

11. The Court of Claims stated in *Michtom v. United States,* ___Ct. Cl.___, ___F.2d___ (1978), that the taxpayer's rights against Hayden Stone "wre not capital assets, for they lacked an essential characteristic of capital assets—the ability to appreciate or depreciate in value over a period of time." We think that this statement is open to question. Section 1221 defines capital assets as "property" with certain specified exceptions. Nothing in that section speaks to the ability of the property to fluctuate in value. The rights of the taxpayer in *Michtom,* as well as the rights of petitioners herein, are clearly "property" and equally clearly they do not fall within any of the exceptions contained in section 1221. A promissory note can be a capital asset. See *Estate of Lehr v. Commissioner,* 18 T.C. 373 (1952); *Ardela, Inc. v. Commissioner,* T.C. Memo. 1969-83. In any event, the value of the bundle of rights in the subordinated agreements of the taxpayer in *Michtom* and of petitioners herein would be affected by changes in the prevailing interest rates and shifts in the business fortunes of Hayden Stone (even in liquidation).

In sum, we hold that petitioners' losses in 1970 should be limited to the excess of the bases in their securities over the amount realized by Hayden Stone on the sales thereof for their accounts. In view of our holding that any deduction for a further loss is precluded by the reorganization provisions of the Code, we do not reach the alternative argument of the respondent that, to the extent that any such loss occurred, it would be a nonbusiness bad debt loss whose deductibility would be governed by section 166.

Decision will be entered for the respondent in docket No. 5315-75.

Decision will be entered under Rule 155 in docket No. 9654-75.

Reviewed by the Court.

APPENDIX "A"
OPINION AND JUDGMENT
OF U.S. COURT OF APPEALS

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 1097—August Term, 1978.

(Argued May 24, 1979 Decided September 5, 1979)

Docket No. 79-4051

JOSEPH LORCH and HANNAH LORCH,

Petitioners-Appellants,

-against-

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

MICHAEL T. HARGES and JANET G. HARGES,

Petitioners-Appellants,

-against-

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Before:
LUMBARD, MANSFIELD and GURFEIN,
Circuit Judges

Appeal from an order of the Tax Court disallowing petitioners' deduction of certain losses under IRC §165(c)(2).

Affirmed.

LEONARD BAILIN, P.C., New York, N.Y., *for Petitioners-Appellants.*

DANIEL F. ROSS, Attorney, Tax Division, Department of Justice, Washington, D.C. (M. Carr Ferguson, Assistant Attorney General, Gilbert E. Andrews, Ernest J. Brown, Attorneys, Tax Division, Department of Justice, Washington, D.C., of Counsel), *for Respondent-Appellee.*

LUMBARD, *Circuit Judge:*

Joseph Lorch and Michael Harges appeal from an order of the Tax Court approving the Commissioner's assessment of deficiencies in their federal income tax returns for the year 1970.[1] Finding that petitioners were not entitled to certain ordinary losses claimed under IRC §165(c)(2) on their 1970 returns, we affirm the decision of the Tax Court.

The facts are undisputed. In January of 1962, Lorch and Harges entered into separate agreements with Hayden, Stone & Company, Inc., a brokerage firm, designed to help Hayden Stone meet the minimum capital requirements of the New York and American Stock Exchanges. The agreements, similar to those Hayden Stone had with over one hundred other investors, required Lorch and Harges each to give to Hayden Stone a noninterest bearing promissory note in the face amount of

1. Petitioners' wives are parties to this proceeding solely by virtue of their having joined in the filing of the 1970 returns.

$100,000, and as collateral on the note, to place securities into an account with Hayden Stone. Petitioners' liability on their notes was expressly limited to the value of the assets in their collateral accounts, and each was free at all times to withdraw any of the securities in his account so long as it was replaced with cash or securities of equivalent value. Although petitioners' rights to the assets in their accounts were subject to Hayden Stone's authority to demand payment on their notes, each otherwise retained full legal and beneficial ownership of his securities, including the right to vote as a shareholder and to receive interest or income distributions.

In return for the obligations undertaken by Lorch and Harges, Hayden Stone agreed to pay them 5% annually on the face value of their notes. Additionally, Hayden Stone was required, in the event that it demanded payment on the promissory notes, to give to each petitioner the firm's subordinated debentures at 6% interest in the face amount each actually paid in satisfaction of his note.[2]

Lorch and Harges maintained their collateral accounts with Hayden Stone and received the 5% annual interest called for by the agreement from 1962 until 1970. In 1970, however, Hayden Stone faced severe financial difficulties and it consequently demanded that its subordinated lenders, Lorch and Harges included, pay their secured notes or face liquidation of the assets in their accounts. In response to the demand, Lorch deposited an additional $10,000 with Hayden Stone and took back certain common stock from his account. Lorch permitted the rest of the securities in his account, in which he had a cost basis of $126,005.51, to be liquidated by Hayden Stone, which ultimately received $80,026.84 upon their sale. Including dividends and interest retained by Hayden Stone and a pre-existing credit balance, all of which amounted to $1,074.75, a total of $91,101.59 was used to satisfy Lorch's obligation to Hayden Stone.

2. Petitioners' arrangement with Hayden Stone was terminable by either party upon six months written notice.

Upon receiving Hayden Stone's call for payment, Harges deposited $66,825.05 with the firm and in return took back all of the securities in his collateral account except for one bond in which his cost basis was $20,000.00. Hayden Stone received $19,460.73 from the sale of that bond, and thus the total amount used to satisfy Harges' obligation to the firm, including $2,269.70 in interest and dividend income retained by Hayden Stone, was $88,592.48.

Hayden Stone's demand for payment from its subordinated lenders did not resolve the firm's financial difficulties, and by September of 1970 Hayden Stone had begun to liquidate its business assets. In order to eliminate the firm's negative net worth and thus reduce the possibility of the firm's being placed in liquidation under court-supervision, the subordinated lenders, petitioners included, agreed to exchange their rights to the firm's as yet unissued debentures for preferred stock. Under the terms of the agreement, Lorch and Harges each received one share of the firm's preferred stock for each $100 in claims against the firm.[3] Altogether, Lorch received 911.01 shares and Harges 885.92 shares. The parties have stipulated that the preferred stock was worth $20 per share at the time petitioners received it. As of May, 1977, the date of trial, neither petitioner had disposed of his stock.

Lorch and Harges each claimed ordinary loss deductions under §165(c)(2) on their 1970 federal income tax returns in the amount by which the sum of the cash in their collateral accounts plus their bases in the securities liquidated by Hayden Stone exceeded the fair market value of the Hayden Stone preferred stock they ultimately received. The Commissioner subsequently issued notices of deficiency against each petitioner.

Following petitioners' appeal, the Tax Court held that the only deductible losses incurred by petitioners were capital losses

3. Among the business assets disposed of by Hayden Stone was the firm name. Consequently the preferred stock received by petitioners was actually issued in the firm's new name, Hayden Stone Equities.

resulting from Hayden Stone's sale of their unredeemed securities and limited in amount to the excess of petitioners' bases in the securities over the amount realized upon sale. The Tax Court determined that Hayden Stone acted as petitioners' agent in selling their unredeemed securities and that petitioners then exchanged the proceeds of those sales together with the additional cash deposited in their accounts for rights to Hayden Stone's subordinated debentures. Although the debenture rights were worth less than the consideration given for them, the Tax Court concluded that no loss on their acquisition was as yet deductible since petitioners' subsequent exchange of their debeture rights for preferred stock was a tax free recapitalization under IRC §368(a)(1)(E).[4]

Not surprisingly, petitioners on this appeal argue that the Commissioner and the Tax Court have mischaracterized their transactions with Hayden Stone. Citing *Stahl v. United States,* 441 F.2d 999 (D.C. Cir. 1970) petitioners contend that in substance the transactions were bailments, petitioners transferring possession and limited use of their pledged securities to Hayden Stone while retaining legal and beneficial ownership. Since the bailments were entered into in the hope and expectation of profit, petitioners claim they are entitled to ordinary loss deductions under §165(c)(2) to the extent that the preferred stock they received from Hayden Stone was worth less than the cash and securities they surrendered.

As the Commissioner has argued, petitioners' attempt to characterize their arrangements with Hayden Stone as bailments disregards the fact that petitioners partially terminated any bailment that existed by redeeming for cash certain of the securities in their collateral accounts before those accounts were liquidated. But even ignoring the extent to which petitioners' analysis collapses separate transaction, into one, petitioners

4. Non-recognition of gain or loss pursuant to a reorganization is provided by IRC §354(a).

cannot, simply by applying the label bailment, alter the fact that the losses they seek to deduct resulted from their agreement to become, at Hayden Stone's option, creditors of the firm through the purchase of its subordinated debentures. Regardless of whether petitioners and Hayden Stone stood as bailors and bailee with respect to the securities deposited in the collateral accounts, the deposit arrangements simply secured petitioners' commitments to pay, upon Hayden Stone's demand and in return for its subordinated debentures, the amount fixed in their promissory notes.

From Hayden Stone's viewpoint the arrangement permitted it to include the taxpayers' assets in its capital for the purpose of meeting the stock exchange's asset requirements. From the taxpayers' point of view, the arrangement enabled them to receive an additional 5% annual income over and above the interest and dividends received by them on the securities deposited with it to secure their obligations to make the loans to it upon demand. The risk the taxpayers took was that Hayden Stone might make such a demand in which event they would be required to honor their commitments to lend it an amount equal to the value of their assets deposited with it to secure their obligations under the arrangement. Thus each transaction amounted to a purchase by Hayden Stone of a call on a line of credit or, alternatively, a put on its debentures, the cost to Hayden Stone being the 5% annual interest it was required to pay petitioners. When the demands for the loans were made, each taxpayer had the right to withdraw any securities by depositing their market value in cash. Thus, when Hayden Stone liquidated the account, it sold the securities, in effect, as custodian for the taxpayer. Hence, the taxpayer was required to recognize gain or loss, as the case may be, on the sale of the securities, and the gain or loss was a capital one. Under the taxpayers' analysis, the net loss would differ depending on whether the taxpayer withdrew the securities, sold them independently and remitted the proceeds to Hayden Stone, or let Hayden

Stone do the selling. Such a procedure would permit considerable tax evasion.

When Hayden Stone demanded payment on the notes its relationship with petitioners became one of debtor-creditor. It is elementary that a taxpayer does not incur a loss when he makes a loan unless the debt is worthless, IRC §165(g), in which event the resulting loss must be considered one from a sale or exchange of a capital asset within the taxable year, IRC §166(d). Such was not the case here, since the taxpayer expected to receive repayment in the form of debentures bearing 6% interest[5] and the debentures, while not worth their face value, would have been far from worthless.

Despite petitioners' reliance on *Stahl,* we do not believe that our characterization of Hayden Stone's and petitioners' eventual relationship as debtor-creditor, with Hayden Stone's debt being evidenced by the subordinated debentures to which petitioners became entitled, necessarily contradicts anything written in that case. The taxpayer in *Stahl,* like the petitioners in this case, loaned securities to a brokerage firm under an arrangement that left the taxpayer with beneficial ownership of the securities. However, the securities were subordinated to claims of the firm's creditors and the taxpayers had no right to redeem them in the event they were needed by the brokerage

---

5. In a case involving another of Hayden Stone's subordinated lenders, *Mitchom v. United States,* 573 F.2d 58 (1978), the Court of Claims held that the taxpayer was entitled to an ordinary loss upon the exchange of his debenture rights for preferred stock. The Commissioner had not argued that the exchange was a tax free recapitalization and the Court of Claims held that taxpayer's debenture rights were not a capital asset because they lacked the ability to appreciate or depreciate over time.

We find the Court of Claims reasoning difficult to comprehend. Even if a necessary characteristic of a capital asset were the ability to appreciate or depreciate, and we know of nothing which suggests that it is, factors such as the soundness of Hayden Stone and the prevailing interest rate could influence the value of its debentures. We note in addition that adherence to the Court of Claims' reasoning would create opportunities never intended by Congress for the conversion of bad debt losses from capital to ordinary.

firm to satisfy its creditors. The Court of Appeals for the District of Columbia concluded that the arrangement constituted a bailment and permitted the taxpayer to deduct from ordinary income the loss sustained when the brokerage firm sold the securities to satisfy creditor claims. The basic rationale for the court's decision, however, was that no debtor-creditor relationship existed between the firm and the taxpayer since the agreement did not clearly obligate the firm to reimburse the taxpayer in the event the taxpayer's securities were sold to satisfy claims of the firm's creditors. In contrast, petitioners' status as creditors of Hayden Stone and the fixed nature of Hayden Stone's obligation to repay them was made unmistakably clear by petitioners' entitlement to the firm's debentures in the event their notes were called.

The final issue that we must address is whether the petitioners suffered a deductible loss when they exchanged their debenture rights for Hayden Stone preferred stock. Petitioners have disputed the Tax Court's finding that the exchange was a tax-free recapitalization, arguing that there was no intent to continue business activity in corporate form since Hayden Stone had already begun the process of liquidation. We find this argument unpersuasive, however. The exchange enabled Hayden Stone to avoid involuntary liquidation and, indeed, it was still in business at the time of trial, some seven years after the exchange. Its business objective during this period was to proceed with the collection of its assets and payment of its creditors while avoiding court-supervised liquidation, and the exchange of debenture rights for preferred stock enabled it to continue with that activity. In all other respects the exchange was an archetypal recapitalization, converting Hayden Stone's net worth from negative to positive but leaving unaffected the priority of petitioners' claims on the firm. Accordingly, petitioners incurred no deductible loss upon the exchange of their debenture rights for Hayden Stone preferred stock.

In sum, we find no basis for granting petitioners tax benefits that are unavailable to ordinary creditors or debenture

holders. Hayden Stone's liquidation of petitioners' securities entitled them to a capital loss in the amount by which their bases in those securities exceeded the proceeds of sale. Petitioners have as yet sustained no other deductible loss.

Affirmed.

APPENDIX "B"
STATUTES

§1254. Courts of appeals; certiorari; appeal; certified questions

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;

(2) By appeal by a party relying on a State statute held by a court of appeals to be invalid as repugnant to the Constitution, treaties or laws of the United States, but such appeal shall preclude review by writ of certiorari at the instance of such appellant, and the review on appeal shall be restricted to the Federal questions presented;

(3) By certification at any time by a court of appeals of any question of law in any civil or criminal case as to which instructions are desired, and upon such certification the Supreme Court may give binding instructions or require the entire record to be sent up for decision of the entire matter in controversy.

SEC. 165. LOSSES.

(a) **General Rule.**—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) **Amount of Deduction.**—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) **Limitation on Losses of Individuals.**—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100 limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return.

Last amendment.— Sec. 165(c) appears above as amended by Sec. 208(a) of Public Law 88-272, Feb. 26, 1964 (qualified effective date rule in Sec. 208(b) of Public Law 88-272, Feb. 26, 1964). Sec. 165(c) as it read before this amendment is in P-H Cumulative Changes.

(d) **Wagering Losses.**—Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) **Theft Losses.**—For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

(f) **Capital Losses.**—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) **Worthless Securities.**—

(1) **General rule.**—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) **Security defined.**—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(e) Securities in affiliated corporation.—For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), anuities, and gains from sales or exchanges of stocks and securities.

Last amendment.—Sec. 165(g)(3) appears above as amended by Sec. 7 of Public Law 85-866, Sept. 2, 1958 (qualified effective date rule in Sec. 1(c)(1) of Public Law 85-866, Sept. 2, 1958). Sec. 165(g)(3) as it read before this amendment is in P-H Cumulative Changes.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

SEC. 166. BAD DEBTS.

(a) General Rule.—

(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of Deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Reserve for Bad Debts.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

(d) Nonbusiness Debts.—

(1) **General rule.**—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) **Nonbusiness debt defined.**—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

Last amendment.—Sec. 166(d)(2)(A) appears above as amended by Sec. 8 of Public Law 85-866, Sept. 2, 1958 (qualified effective date rule in Sec. 1(c)(1) of Public Law 85-866, Sept. 2, 1958). Sec. 166(d)(2)(A) as it read before this amendment is in P-H Cumulative Changes.

(e) **Worthless Securities.**—This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) **Reorganization.**—

(1) **In general.**—For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation) of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or one or more of its shareholders (including persons who were

shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

Last amendment.—Sec. 368(a)(1) appears above as amended by Sec. 218(a) of Public Law 88-272, Feb. 26, 1964 (qualified effective date rule in Sec. 218(c) of Public Law 88-272, Feb. 26, 1964). Sec. 368(a)(1) as it read before this amendment is in P-H Cumulative Changes.

(2) **Special rules relating to paragraph (1).**—

(A) Reorganizations described in both paragraph (1)(C) and paragraph (1)(D).—If a transaction is described in both paragraph (1)(C) and paragraph (1)(D), then, for purposes of this subchapter, such transaction shall be treated as described only in paragraph (1)(D).

(B) Additional consideration in certain paragraph (1)(C) cases.—If—

(i) one corporation acquires substantially all of the properties of another corporation,

(ii) the acquisition would qualify under paragraph (1)(C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1)(C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation,

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1)(C). Solely for the purpose of determining whether

clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation, and the amount of any liability to which any property acquired by the acquiring corporation is subject, shall be treated as money paid for the property.

(C) Transfers of assets or stock to subsidiaries in certain paragraph (1)(A), (1)(B), and (1)(C) cases.—A transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock.

Last amendment.—Sec. 368(a)(2)(C) appears above as amended by Sec. 218(b)(1) of Public Law 88-272, Feb. 26, 1964 (qualified effective date rule in Sec. 218(c) of Public Law 88-272, Feb. 26, 1964). Sec. 368(a)(2)(C) as it read before this amendment is in P-H Cumulative Changes.

Internal Revenue Code of 1954

(D) Statutory merger using stock of controlling corporation.—The acquisition by one corporation, in exchange for stock of a corporation (referred to in this subparagraph as "controlling corporation") which is in control of the acquiring corporation, of substantially all of the properties of another corporation which in the transaction is merged into the acquiring corporation shall not disqualify a transaction under paragraph (1)(A) if (i) such transaction would have qualified under paragraph (1)(A) if the merger had been into the controlling corporation, and (ii) no stock of the acquiring corporation is used in the transaction.

Addition.—Sec. 368(a)(2)(D) was added by Sec. [1] (a) of Public Law 90-621, Oct. 22, 1968, effective (Sec. [1] [c] of Public Law 90-621, Oct. 22, 1968) with respect to statutory mergers occurring after Oct. 22, 1968.

(b) **Party to a Reorganization.**—For purposes of this part, the term "a party to a reorganization" includes—

(1) a corporation resulting from a reorganization, and
(2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

In the case of a reorganization qualifying under paragraph (1)(B) or (1), (c) of subsection (a), if the stock exchanged for the stock or properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to a reorganization" includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1)(A), (1)(B), or (1)(C) of subsection (a) by reason of paragraph (2)(C) of subsection (a), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets or stock are transferred. In the case of a reorganization qualifying under paragraph (1)(A) of subsection (a) by reason of paragraph (2)(D) of that subsection, the term "a party to a reorganization" includes the controlling corporation referred to in such paragraph (2)(D).

Last Amendment.—Sec. 368(b) appears above as amended by Sec. [1](b) of Public Law 90-621, Oct. 22, 1968, effective (Sec. [1](c) of Public Law 90-621, Oct. 22, 1968), with respect to statutory mergers occurring after Oct. 22, 1968.

Prior amendment.—Sec. 368(b) was previously amended by Sec. 218(b)(2) of Public Law 88-272, Feb. 26, 1964 (qualified effective date rule in Sec. 218(c) of Public Law 88-272, Feb. 26, 1964), Sec. 368(b) as so amended is in P-H Cumulative Changes.

(c) **Control.**—For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

APPENDIX "B"
SECURED NOTE

$1000,000.00 New York, New York Jan. 2, 1962

FOR VALUE RECEIVED, I promise to pay to Hayden, Stone & Co. Incorporated (the "Corporation") at its principal office at 25 Broad Street, New York, New York (where presentment and demand for payment shall be made), without interest, the sum of One hundred thousand Dollars ($100,000.00), on demand.

This Note is secured at its date by the pledge of the securities and cash, if any, described in Schedule A annexed hereto.

This Note and the securities and cash from time to time pledged to secure it are subject in all respects to the provisions of a Collateral Agreement of even date between the Corporation and the undersigned, a copy of which may be examined at the principal office of the Corporation.

The Corporation, by acceptance hereof, agrees, for itself, its representatives, successors and assigns (1) that neither I, my heirs, executors, administrators or assigns shall be personally liable on this Note, it being intended that my obligation to pay the principal amount of this Note is included for the sole purpose of establishing the existence of the indebtedness represented hereby, (2) that in the event of default the Corporation and any such successor or assign, shall look for payment solely to the security of the property then pledged to secure the same, and will nt make claim or institute any action or proceeding against me, my heirs, executors, administrators or assigns for the payment of this Note or for any deficiency remaining after application of the property pledged to secure this Note, or otherwise; provided, however, that nothing herein contained shall be construed to release or impair the indebtedness evidenced by this Note, or of the lien upon the property pledged

to secure it, or preclude the application of said pledged property to the payment hereof in accordance with the provisions of Paragraph X(c) of the Collateral Agreement.

s/
Payor